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Reforming Sweden's budgetary institutions – Background, design and experiences

Per Molander and Jörgen Holmquist

Per Molander was the main architect of the Swedish budget reform in the 1990s. He is currently Director-General of the Swedish Social Insurance Inspectorate.

Jörgen Holmquist was the Budget Director in the Swedish Ministry of Finance (1993–1997) and Director General in the European Commission (2002–2010).

The views expressed in this report are those of the authors and do not necessarily represent those of the Swedish Fiscal Policy Council.

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Finanspolitiska rådet
Box 3273
SE-103 65 Stockholm
Kungsgatan 12–14
Tel: 08-453 59 90
Fax: 08-453 59 64
info@finanspolitiskaradet.se
www.finanspolitiskaradet.se

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Abstract

The task of budgetary institutions is to solve or, at least, alleviate a number of the problems associated with collective decision-making in the political sphere. The successful design of institutions requires that these problems be precisely characterised and that appropriate solutions be developed. To some extent, the objectives connected with different problems are conflicting, which leads to difficult trade-offs that are both technical and political in nature. The present report discusses these trade-offs against the backdrop of the Swedish budgetary reforms carried out in the 1990s. It also discusses why certain solutions were chosen and others not and provides indications of the effects of these budgetary reforms on public finances in Sweden.

Summary

The size of the Swedish public sector in relation to GDP was similar to the OECD average until the early 1960s. During the following 30 years, it grew more rapidly, and by the mid-1990s, the Swedish public sector was substantially larger than those in most similar OECD countries. During this 30-year period, Sweden went through two major public finance crises. Only after the second one, in the early 1990s, were major changes made to the budget process (here referred to as the budget reform).

Since the budget reform, the trend for Swedish public finances has changed. The central government public sector, including the social security sector, has shown surpluses almost every year and the government debt-to-GDP ratio has been reduced from over 75 per cent to about 30 per cent. The public sector has also become smaller in relation to GDP and is now of the same magnitude as those in other similar OECD countries.

Several factors have contributed to this important change in Swedish public finances, but there are strong reasons to believe that the budget reform made an important contribution. The reform implied important changes in how the public sector budget is decided and managed and it has been successful thanks to its broad political support. The way the reform was designed and implemented explains why this political support is still strong after almost 20 years.

The main technical elements of the reform were:

- concentration on public expenditure, which had been difficult for the political system to manage in the preceding decades,
- using the budget balance only as a target for general economic policy, not as an instrument for the control of public sector finances, since it is difficult to make it operational for decisions on and the implementation of the budget,
- top-down approach to budgeting, both in the government and in parliament,
- introduction of nominal expenditure ceilings set for a three-year period,
- establishing expenditure ceilings both for total expenditure (except interest on government debt) and for 27 expenditure areas including social security, as well as the pension system,
- completeness of the budget, that is, no extra-budgetary funds, and the inclusion of central government guarantees to the extent that they are not financed by market-based fees,
- gross budgeting, i.e., no netting of expenditure against revenue,
- dismantling of open-ended appropriations (in the social security system, too),
- monthly in-year follow-up of expenditure,

- economic/administrative rating of all government agencies,
- a budget act, specifying the freedom of action of the government vis-à-vis parliament.

The technical improvements in the budget system led to important changes in the incentives for all actors in the budget process, reflecting a conviction that responsibility for financial or other matters must be assigned at the individual level in order to be effective.

Other changes not formally part of the reform but generally supportive of the overall goals were also made. Most importantly, a balance requirement was introduced for local government. Together with the pre-existing agreement that cost increases in local government caused by parliamentary decisions at the national level should be compensated, this precludes the shifting of responsibilities and costs (and implicitly deficits) to municipalities and regional county councils.

The wide support of the reform was explained by the need felt by politicians to be able to control public finances as well as by the design and implementation of the reform. The principal aim of the reform was explicitly to enhance the powers of political institutions, giving them an effective instrument to control and allocate public sector expenditure. The intention was thus not to move decision-making power away from political institutions and place it in the hands of technocrats or to resort to automatic rules. This approach is of fundamental importance for explaining the continued and strong political support for the reform.

The reform did alter the balance of power within the political system. The role of bodies responsible for general economic policy and sound public finances was strengthened: in parliament, the Standing Committee on Finance, and in the government, the Prime Minister's Office and Ministry of Finance. Indirectly, the reform probably also strengthened the ability of the leaders of the political parties in opposition to achieve decisions on the priorities for public finances.

Other factors have also contributed to the success of the budget reform. One is that the basic principles of the budgeting system are clear and simple, which makes it easy to explain and, as a consequence, gain popular support. Furthermore, the arguments for the reform were not defensive but positive, pointing to the value of being able to achieve a desired allocation of public sector expenditure and to properly manage public sector finances, with favourable effects on general economic performance and living standards.

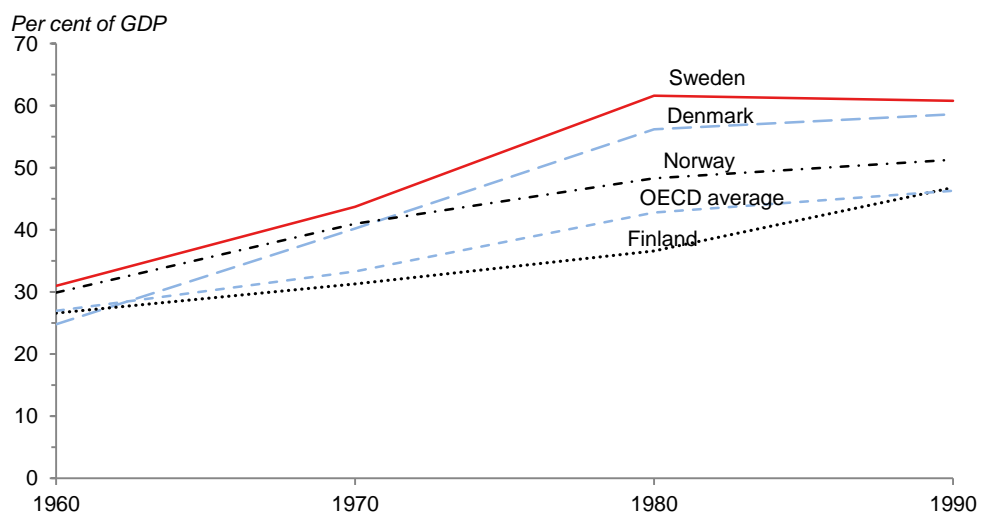
The reform was based on a solid understanding of international empirical research in the areas of public finance and decision-making systems. The presence of "entrepreneurs", both among politicians and civil servants, was a prerequisite in the process leading up to the reform, as were organisational changes in the Ministry of Finance. Finally, the general political climate was favourable to reforms that improved the functioning of the Swedish economy.

1 Background and short overview of the reform process

1.1 Swedish public finances since 1960 from an international perspective

Since the Second World War, the economies of OECD countries have generally grown at a rapid rate, albeit with periods of slower growth. The public sector has grown even faster in all countries and the public sector as a percentage of GDP has steadily increased, although growth rates differ markedly between OECD countries. The development of the Swedish public sector is illustrated in Figure 1, which shows that the size of the Swedish public sector was similar to those of other OECD countries in the early 1960s. The following three decades were characterised by more rapid growth in the share of GDP compared with other countries. This is also true in comparison with Norway and Finland, while the development in Denmark was in many ways similar to that in Sweden.

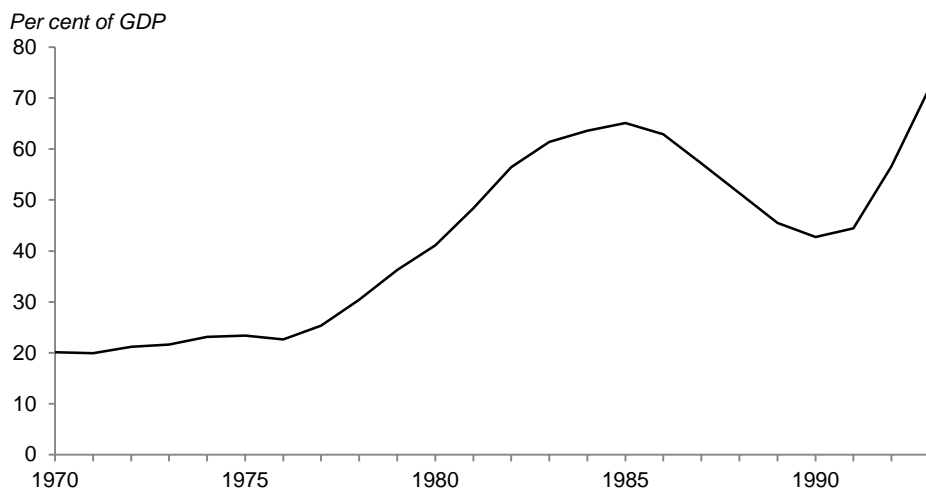
Figure 1 Total government outlays in Nordic and OECD countries 1960–1990



Source: OECD.

Since the Second World War, Sweden has experienced two crises in public finances. The first occurred in the late 1970s and early 1980s, resulting primarily from inflationary economic policies, rapid growth in public expenditure and a fixed exchange rate. This resulted in a public sector savings deficit of 8 per cent of GDP in 1981. The second public finances crisis occurred in the early 1990s primarily as a result of an overheated economy, a bubble in the financial and real estate markets and, again, a fixed exchange rate in an economy with a higher inflation rate than those in surrounding economies. This resulted in a financial crisis in 1992 and a public sector savings deficit of 11 per cent of GDP in 1993. In the interval between these two crises, the government managed to control public finances, resulting in a government debt-to-GDP ratio illustrated in Figure 2.

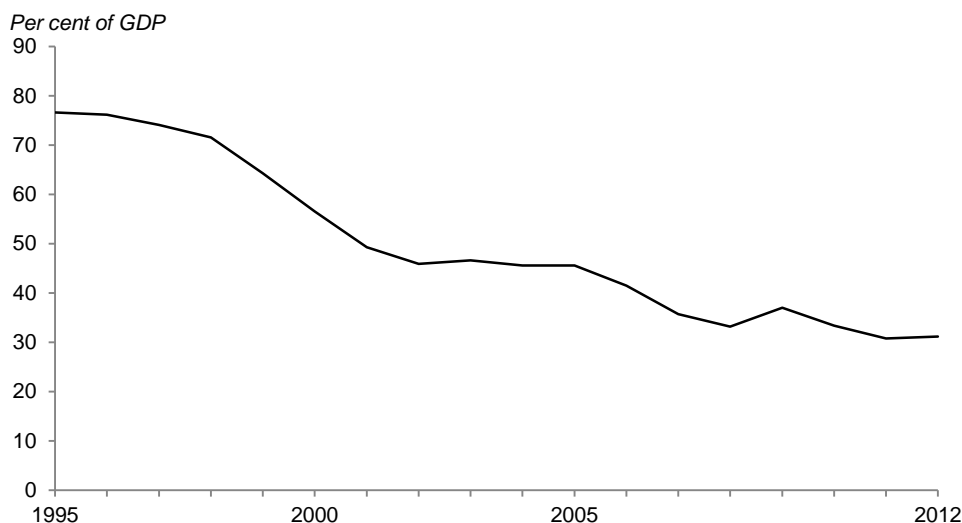
Figure 2 Central government debt in Sweden 1970–1993



Source: ESV.

This development has reversed in the past two decades, and Sweden has seen a gradual but consistent reduction in the public expenditure share of GDP, which is now closer to the averages for European and Nordic OECD countries. This is a development that almost all political parties have supported. The reduction in public sector expenditure to GDP started shortly after the centre-left social-democratic government took office in 1994, but it was to some extent influenced by cuts in expenditure by the preceding centre-right government after the financial crisis in 1992. The social-democratic government stayed in office for 12 years until 2006 when it was replaced by the current centre-right government under which the GDP share of public sector expenditure has continued its gradual downward trend.

Figure 3 Central government debt in Sweden since 1995



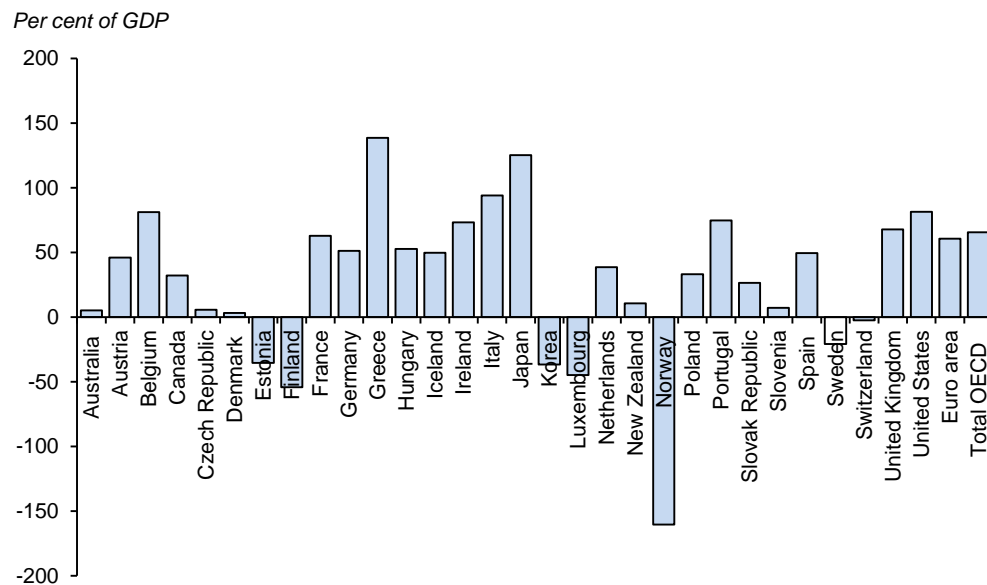
Source: ESV.

The improved control of the development of public sector expenditure combined with a well-functioning tax and tax collection system has resulted in net savings in the public sector in most years during the past decade and a half.

This has also been an explicit policy supported by almost all political parties and has led to a gradual, continuous and over time substantial reduction in the share of GDP of central government debt, as shown in Figure 3.

As shown in Figures 2 and 3, Swedish debt to GDP rose until 1995 since which it has reduced by more than half. The financial crisis hitting Europe and the US in 2008 has had only a limited impact on this development. This compares favourably with the general picture in the OECD, as illustrated in Figure 4.

Figure 4 Government debt in 2011 for OECD member states



Note: The OECD definition of debt uses a net concept that differs from the one used in the previous figure.
Source: OECD.

The development of public sector finances in Sweden thus changed its course in the mid-1990s, and this change has proven to be stable. Part of the explanation is the decisions on public expenditure and taxes taken in the years immediately after the financial crisis in 1992. However, unlike after the public finances crisis in the late 1970s and early 1980s, this improvement has continued long after the crisis itself. It is our view that the main reason for this is the Swedish reform of the budgetary institutions in the mid-1990s that took full effect in 1997. The rules governing the preparation and decisions on public sector budgets are of paramount importance for this development, but the strong and continued support for this reform from almost all political parties is an equally important reason for its success.

1.2 Earlier attempts

As a result of the public finances crisis in the late 1970s and early 1980s, successful policies were pursued by different governments in order to improve public finances through reductions in expenditure and increased revenues. These results did not last, as already mentioned, and a new public finances crisis erupted 10 years later. By the early 1980s, some had already realised that

although Swedish political institutions were capable of addressing an immediate crisis in public finances, they were obviously not sufficiently strong to prevent the development of such a crisis. In the Budget Department of the Swedish Ministry of Finance, this was discussed in the early 1980s but no major changes to the budgeting system were proposed. At that time, civil servants analysed the possibility of setting expenditure levels in nominal terms, which were not to be adjusted upwards for higher than expected inflation, i.e., something similar to the expenditure ceilings introduced as part of the Swedish reform in the mid-1990s. These ideas, which were inspired by reforms in the UK, were rejected as impossible to implement, particularly in an environment with fairly high and variable inflation. The analysis did not go very deep and was not, or only to a very limited extent, discussed with the Minister of Finance.

It was clear to the civil servants in the Ministry of Finance most involved in the management of public sector finances that the problem consisted of controlling the development of public expenditure when the economy was strong, usually as a result of a devaluation of the currency. Deficit targets were seen as politically important but not operational and thus having a very limited effect on the development of public sector finances. There was at this point no general political support for a stricter budget process. Confidence in the existing processes had not been deeply shaken by the first crisis, since Sweden seemingly managed to find a way out of it. Moreover, concrete and operational reform proposals were not developed, partly because there was little interest in them and partly because the resource-consuming annual budget process and the organisation of the Budget Department in the Ministry of Finance left little room for reform planning.

1.3 The 1992 ESO report

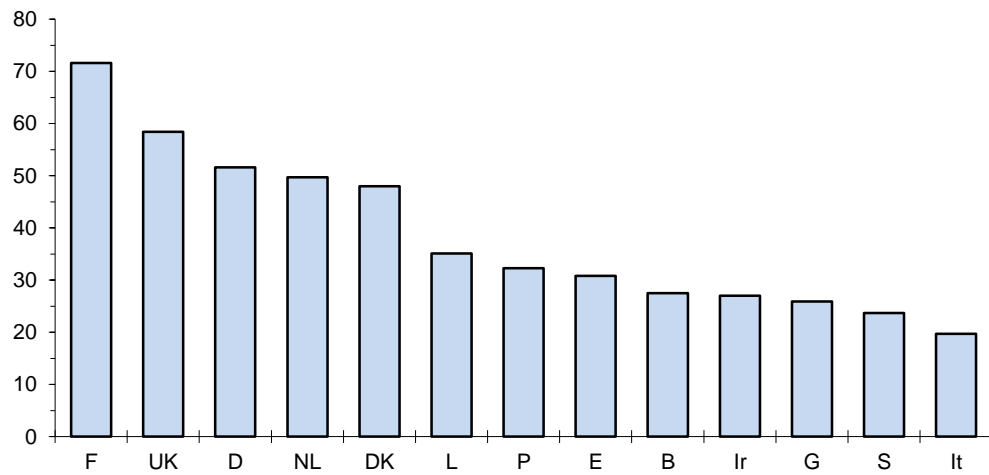
As part of the preparations for the Maastricht Treaty, the European Commission engaged Professor Jürgen von Hagen to analyse the budget processes of the 12 member states. The basic question was whether these national budget processes were strong enough to make the Maastricht Treaty credible. Von Hagen collected verbal descriptions of the budget processes using a questionnaire comprising 24 questions illuminating various aspects of these processes. This was not new; similar work had been carried out before by the OECD secretariat.¹ What was new was that von Hagen correlated these descriptions with fiscal outcomes such as deficit and debt by translating the qualitative information about the budget processes into a quality index in order to test the effect of institutional characteristics. This work proved successful; one of the indices tested explained about one-third of the variation in outcome, which is enough to justify discussions about institutional reform in countries that came out poorly in the analysis. In general, it is important to make a distinction between correlation and causality, but in the present case

¹ OECD (1987).

this is less of an issue, because budgetary institutions are very seldom changed; the direction of causality is clear.

While this work was being conducted, one of the authors (Molander) got in touch with von Hagen and used the same questionnaire in Sweden. Von Hagen's report to the Commission was published in October 1992,² and Molander's (normally referred to as the ESO report) followed in December the same year.³ The outcome for Sweden, which was very clear, is shown in Figure 5.

Figure 5 Structural index of the strength of the budget processes for the 12 member states and Sweden in 1992



Source: Molander (1992).

An immediate conclusion to be drawn from the analysis was that the potential for improving Sweden's budgetary institutions was substantial. The recommendations presented in the report were the following:

- The rules governing various forms of appropriations have to be reconsidered; open-ended appropriations are dysfunctional from a control perspective.
- The coordinating roles of the Prime Minister's Office and Ministry of Finance in the internal budget process of government offices have to be strengthened.
- A top-down approach must be applied in the government office budget process.
- Similarly, a top-down approach should be applied in parliament, starting from an aggregate budget decision in parliament.
- Changes to the budget proposal in parliament should be restricted to the aggregate bounds already voted on.

² Von Hagen (1992).

³ Molander (1992). ESO is an expert group on public finance that is formally a committee under the Ministry of Finance but that is autonomous in its choice of topics and methods of analysis.

- A less status quo-oriented approach to expenditure is desirable, based on a systematic review of government commitments in all areas.
- The budget must be complete. Government expenditure including extra-budgetary funds must be covered by budget documents and budget decisions.
- Focus on scrutiny and evaluation should be strengthened in parliament.

The result from the analysis was summarised in the following way in the report (p. 28): “An improvement of the process corresponding to 30 units, which would take Sweden to the level of the Netherlands or Germany, would in the long-run imply a reduction of central government debt by 30 per cent of the GDP and bring it back to historically more normal levels.” This turned out to be what was eventually accomplished in the reform.

1.4 Parliamentary reform

The report on the Swedish budget process was published at the same time as a parliamentary committee led by the chairman of parliament was considering the general work procedures and routines applied in parliament. This work was not specifically focused on the budget process, but the report drew attention to the weaknesses of parliamentary budget procedures, and the final report from the committee put forward a number of proposals in line with what had been suggested in the ESO report.⁴

Because the suggestions from the parliamentary committee involved constitutional changes, they had to be decided on two occasions, before and after the elections in 1994. The most important changes were:

- An orthodox top-down approach to budget decision-making, in which parliament first votes on total expenditure and bounds for the expenditure areas, followed by votes on single budget items subject to the preceding vote;
- A new partition of the central government budget, based on 27 expenditure areas;
- Transition to calendar year and increased importance of the Spring Fiscal Policy Bill.

1.5 Continued reform – the expenditure ceiling

When parliament had taken care of its own share of the central government budget process, it remained for the government to strengthen the other parts – basically the preparatory phase and implementation following parliament’s decision on the budget. This work started early in 1994 and took off later the same year; the result was presented to parliament by the Minister of Finance in

⁴ Talmanskonferensen (1994).

December 1995.⁵ Important input to this work was a request from the political leadership to create some form of “expenditure target”. The substance matter of this request was relatively vague, and it was up to the experts of the Ministry of Finance to develop the idea into an operational instrument of fiscal policy: the expenditure ceiling.

The proposals in the 1995 report were applied in full in 1996 during the preparation of the budget for 1997. The proposals were formally in force from January 1st, 1997. The main components of the reform package were:

- an orthodox top-down budgeting procedure starting from fiscal policy goals at the aggregate level (preparation in government offices and decision-making in parliament);
- a nominal, tri-annual ceiling for state expenditure;
- a budget margin to handle planning uncertainties;
- dismantling open-ended appropriations;
- a complete state budget based on the gross budgeting principle (no netting of expenditure against revenues);
- tax expenditure accounts in the form of an appendix to the budget, summarising the effect of all deviations from standard tax rates, exemptions, deductions, etc.;
- improved forecasting (related to the dismantling of open-ended appropriations);
- comprehensive in-year monthly follow-up of expenditures relative to budget figures;
- improved performance measurement, aiming at a comprehensive set of indicators;
- improved annual budget cycle, with a stronger emphasis on the Spring Fiscal Policy Bill;
- economic/administrative rating of agencies, based on self-reporting from them combined with sample control from the National Financial Management Authority;
- annual reports on the measures taken by the government on account of the audit reports from the National Audit Agency;
- a budget act, specifying the freedom of action of government vis-à-vis parliament in the fiscal policy area.

⁵ Molander et al. (1995).

1.6 Later changes and amendments

The expenditure ceiling and top-down approach are neutral in the sense that they do not as such imply any particular fiscal policy. For the first three years, the expenditure ceiling was designed based on discretionary political decisions. The strongest binding restriction was to reach a zero budget balance for the fiscal year 1998, a goal that was reached.

In order to govern the process in the medium term, a permanent surplus target was introduced in 2000. It was set at the level of a 2 per cent surplus on average over the business cycle, a target that has been kept, although the current figure is 1 per cent rather than 2, because part of the pension fees are now considered to belong to the private sector (although mandatory).

The budget act was updated in 2010. The most important change was that the expenditure ceiling, which had hitherto been facultative, was now made mandatory following the generally positive experiences of the first 10 to 15 years.

2 Trade-offs, design principles and solutions chosen

2.1 The need for budgetary institutions

In the area of public budgeting, an efficient decision procedure is one in which the costs and benefits of a public undertaking are traded fairly against one another. It is further one in which decisions on expenditures and revenues are based on information that is accurate enough for decision-makers to be able to make conscious choices about public sector financial saving – whether guided by balance requirements, a golden rule requirement or other types of targets. Finally, credible projections not only of immediate but also of distant future costs and benefits are a prerequisite for balanced decisions. These requirements are far from always met.

In the absence of budgetary institutions, parliamentary decision-making would not reflect actual political preferences. There are a number of “market failures” that will lead to inefficient outcomes, for instance when individual or party preferences are aggregated in parliament, when sector perspectives are confronted with global budget constraints, when information is incomplete or when the consequences of decisions taken extend beyond the near future.⁶

Aggregation of preferences

Ever since Condorcet’s investigations during the latter half of the 18th century, it has been known that majority decisions in groups do not always generate a stable solution. Arrow re-discovered and developed these results in his well-known impossibility theorem, which have been further refined by Plott, McKelvey and Schofield.⁷ Banks (1995) showed that the risk of chaos depends on the number of dimensions of the decision at hand and the number of voters, in the sense that the higher the number of dimensions, the greater is the risk of instability. Stability will consequently be enhanced if the number of dimensions is reduced.

The common pool problem, fiscal illusion and deficit bias

Another problem, normally referred to as *fiscal illusion*, stems from the asymmetric character of information on costs and benefits⁸. Benefits associated with a particular undertaking are often clearly visible and more or less immediate. Costs, by contrast, are uncertain or unknown, and they are often incurred with a time lag. This asymmetry tends to bias the trade-off between costs and benefits, favouring overspending.

A similar problem appears under the heading of *deficit bias*. Estimates of expenditures and revenues associated with a particular decision are necessarily uncertain, as they depend on behavioural assumptions. Second- and higher-

⁶ The problems discussed below are treated in detail in Molander (2001).

⁷ See Nurmi (1998) for a survey.

⁸ Buchanan and Wagner 1977.

order effects are also notoriously difficult to appreciate, and experience shows that dynamic effects are as a rule underestimated. Given that tax bases tend to evade taxation, whereas beneficiaries tend to be attracted to expenditure programs, this incompleteness with respect to dynamic effects is a potential source of deficits.

These two problems of fiscal illusion and deficit bias are interrelated. They both stem from incomplete knowledge and the asymmetric nature of this incompleteness. To these problems may be added a third, namely that public expenditure is collectively financed and, as a consequence, that a minister in the cabinet or a party in parliament arguing for expenditure in some area does not bear the full cost of the proposal. This *common pool* or *free-riding* problem will contribute further to the imbalance between the costs and benefits of public undertakings.

The above conclusion about the effect of various imbalances does not necessarily require public choice-type assumptions about disproportionately powerful interest groups, regulatory capture and the like. In the presence of such distortions, bias will of course be aggravated.

Time inconsistency and myopia

A different but related problem in public decision-making is connected with time horizons. A classical article by Kydland and Prescott (1977) highlights the risk of inconsistency and the non-optimality of discretionary decision-making over time. There is also a wealth of literature analysing the shortcomings of human decision-making over long time horizons, and our ways and means of coping with these shortcomings.⁹

The normal discounting of cost and benefit flows assumes an infinite time horizon, but politically relevant time horizons are most often very far from infinite. In view of the asymmetries referred to above, the mismatch between analytical and political timeframes is yet another potential source of overspending and deficits. The connection between average government tenure and deficit problems is statistically significant.¹⁰ The longevity of governments in turn depends on institutional parameters such as the voting system (with the degree of political fragmentation in parliament as an intermediate variable) and the length of the electoral cycle.

A limited time horizon may affect political decision-makers in different ways. The risk of being ousted from power is obviously an important parameter, and the government's ideological position can also play a role.¹¹ The long perspective of intergenerational distribution is also relevant to the deficit policy chosen.¹² Among these parameters, the electoral period and possibly the voting system can be considered to be candidates for reform considerations.

⁹ See e.g. Akerlof (1991), Elster (2000) and Loewenstein et al. (2003).

¹⁰ Roubini and Sachs (1989).

¹¹ Persson and Svensson (1989) and Alesina and Tabellini (1990).

¹² Cukierman and Meltzer (1989) and Kotlikoff (1992).

Principal–agent problems

In order to analyse the relationships between voters, politicians and public administration as well as the outsourced production of public services, it may be fruitful to see these relationships as a chain of principal–agent links. Voters choose their representatives in parliament in general elections. The outcome determines the choice of government (within certain bounds), who has a public administration at its disposal in order to implement its policies. This administration can choose to hand over production responsibilities to external producers.

For such a relationship to work properly, three things are needed: a *contract*, *information* about the way the agent accomplishes his or her task and *rewards and sanctions* to be used as a response from the principal. In the political sphere, all these requirements give rise to difficulties. All contracts are incomplete, and particularly so in the political sphere. Information is also incomplete and further muddled by political interests. Rewards and sanctions – basically being re-elected or ousted from power – arrive with a time lag, and although forceful, are also blunt instruments.

2.2 Institutional and political trade-offs

A *regulatory framework for fiscal policy* consists of a number of norms, procedures and admissible outcomes that restrict the spectrum of policies. This is broader than the Kopits and Symansky definition of a *fiscal rule*, understood as something that imposes a long-lasting constraint on fiscal policy through numerical limits on fiscal aggregates.¹³ Indeed, one of the important trade-offs in institutional design is what should be regulated in terms of outcomes and what is best referred to procedural rules or norms.

A number of dimensions and design parameters are open to the architect of a regulatory framework. The design may be circumscribed by constitutional or other restrictions, but the number of combinations available is still large.

Status of the regulatory framework

The status of the fiscal policy framework varies significantly across the countries that have adopted some form of restrictions in this field. To some extent, this reflects the status of the budget itself. In many countries, the budget is legally equivalent to a temporary law. In Sweden, by contrast, the budget is a parliamentary decision, implying an authorisation to spend but not in itself having the status of a law. In the Netherlands, some of the most important restrictions are decided at the beginning of each electoral period as part of a coalition agreement. It is, of course, also possible for a single-party government to declare a self-imposed long-term restriction in order to add to the credibility of its fiscal policy.

Procedural rules and norms are normally laid down in a budget act or organic budget law (*loi organique*). In some countries, the budget act takes precedence

¹³ Kopits and Symansky (1998) and Schaefer et al. (2012).

over other legislation, representing an intermediate between law and constitution. A few countries – France, Germany, Poland, Spain and Switzerland – have chosen to fix fiscal rules in the constitution, and a few others are underway.¹⁴

For members of supranational entities such as the European Union, some restrictions are imposed as a result of the international agreement signed. Such restrictions represent the minimum platform; member states are, of course, free to introduce more stringent rules at the national level.

Coverage

The majority of supranational balance and debt rules adopted across the world cover general government, but this is less common among national rules, which are more often restricted to central government. Federal states are often tied by their constitutions, but unitary states such as the Nordic countries also have to recognise the long tradition of local self-government when designing their fiscal policy frameworks. Even restricting attention to central government, most fiscal rules exclude parts of public expenditure for various reasons – investments, interest on government or transfers. Obviously, there is a limit to these exceptions if the fiscal framework is to retain its credibility.

In Sweden, there is a strong tradition of local autonomy. For instance, municipalities have the right to tax their member citizens, using a proportional tax on labour incomes. For this reason, a binding expenditure ceiling cannot be imposed by the central government. The requirement for a balanced budget, by contrast, has been considered to be compatible with local autonomy, and this was also the alternative chosen.

Unfunded mandates represent a problem in many federal countries, and the risk of such mandates increases the restrictions imposed at the national level. In Sweden, such a possibility is barred by an agreement between the government and the Association of Regional and Local Authorities, implying that decisions at the central level that impose costs on lower levels should be compensated via transfers.

Political involvement

Any form of long-term restriction on fiscal policymaking presupposes a decision whereby political decision-makers at a particular point in time consciously limit the freedom of action of future decision-makers (which may be their own freedom of action). Such limits may take different forms. An extreme form is a rule that automatically releases some form of action when a particular situation arises, for instance when the public deficit exceeds a predetermined limit. A softer form of restriction is one that leaves room for discretion when the situation arises. The former variant may seem to be more efficient at first sight but it runs the risk of losing legitimacy in the eyes of the public or even among decision-makers when some time has elapsed and the originators of the rules in question have left the political arena.

¹⁴ Schaecter et al. (2012).

Uncertainty and flexibility

A critical trade-off problem is that of choosing the appropriate level of flexibility. Budget decisions are made under uncertainty, and the design problem consists of providing the right tools for managing this uncertainty. If the level of flexibility is too high, future decision-makers will too easily evade these restrictions, and fiscal policy will slacken. If, by contrast, flexibility is insufficient, restrictions will most likely be considered to be unreasonable. The framework will lose its legitimacy and be abandoned.

For this reason, escape clauses of various designs can be found in many fiscal policy frameworks. Typically, these refer to macroeconomic disturbances (recessions, growth slowdowns) or to natural disasters. They can also lack specificity (“disturbance of the macroeconomic equilibrium” or “exceptional circumstances”), in which case the credibility of the whole framework is endangered.

Good practice requires a limited range of factors that allow for the use of the escape clause, clear operational guidelines for the acute situation and a specified path to be followed until the economy and public finances are back on track.¹⁵

Budget constraints versus entitlements

One source of problems lies in the nature of public expenditure. A relatively large proportion of public expenditure is non-negotiable in the short-run. The bulk of this expenditure is bound by legislation, for instance in the area of social security. A smaller but important proportion is tied by legal obligations of a different character; typical examples include interest on central government debt and commercial guarantees. The state simply cannot retreat from such obligations without incurring a complete loss of credibility and substantial costs, political as well as financial. As a consequence, a binding budget constraint on the entire expenditure cake or a slice thereof is inadequate as a means of imposing restrictions on public spending. A simple cash limit on, for instance, an appropriation for child allowances or pensions is not a viable alternative.

In some contexts, for instance in the budgetary framework of the EU, different categories are labelled *mandatory* versus *non-mandatory* expenditures. This dichotomy is too simple, however; the inertia of expenditures varies continuously and may be more or less dependent on discretionary decisions by the administrators in charge of a given system. A child allowance is completely bound by the legislative framework, in the sense that it prescribes a certain sum per month to be paid out. Who qualifies for this allowance is in most cases not open to discussion. Unemployment support, on the contrary, has a number of qualifications attached to it, such as what kind of alternative employment the applicant can be required to accept and what commuting distances are reasonable. This calls for a number of discretionary decisions by the administering agency, and consequently lends some flexibility to

¹⁵ Kumar et al. (2009).

implementation. Other types of expenditure, such as regional support systems and industrial subsidies, normally give the agency in charge even more freedom of action.

As a consequence, it seems to be more relevant to differentiate between various expenditure systems with respect to their *inertia* or *time constants*. Characteristic time constants depend on a number of factors, material as well as administrative. A crucial point is whether the governing rules are laid down in detail in a law or just outlined, with the details being specified in a government decree or ordinance. In the latter case, rules can be changed by simple government decisions, which speed up the process substantially.

Responsibility and accountability

The most difficult part of institutional design in this area may be to create the necessary link between aggregate economic targets and decision-making at the micro-level. Political documents and speeches abound with declarations on the necessity to contain expenditure, bring public finances into balance, keep inflation down and the like. Whether such goals are reached does not depend on the intensity of these declarations, however, but on decisions at lower levels of the decision-making hierarchy, among single ministers, high-ranking public officials and civil servants at the grassroots level. For a program of stabilisation and continued fiscal responsibility to work, it is necessary to establish links between the overarching goals of fiscal policy and micro-level decision-making. Aggregate restriction must be felt by human beings making everyday decisions. This sounds simple in principle, but it has far-reaching consequences for the design and is difficult to realise in practice.

An important building block in this context is a clear structure of accountability, which preferably ties expenditure blocks or single budget items to identifiable actors, such as ministers or civil servants.¹⁶ However, the responsibility aspect also has direct consequences for the technical design of budget appropriations.

Target variables

Fiscal rules may target a number of aggregates. Because the fiscal policy dilemma is most often identified as a debt problem, rules on the *deficit* or *debt* are easy to communicate. They are also relatively easy to monitor, although both deficit and debt, as with other aggregate variables, are dependent on definitions. The major argument against the deficit as a target variable is that it is the difference between two large and variable aggregates: revenues and expenditures. The variance in the deficit is of the same order of magnitude as that in revenues and expenditures, while the deficit itself is much smaller. As a consequence, volatility in the deficit makes it impractical as a policy variable. The debt is more stable, but the short-run impact on the debt from fiscal policy is both unclear and limited. Both these targets are thus liable to produce countercyclical fiscal policies if applied.

¹⁶ For a development of this aspect, see the Swedish Tsunami Commission (2005), in particular Appendix 5.

The *structural budget balance* maintains a strong link to the deficit and the debt while eliminating some of the drawbacks: volatility is reduced, as is the risk of countercyclical policy measures. By contrast, the correction for business cycle effects is complicated, particularly when the economy is far from equilibrium. Not only is the computation complicated, but also there is no consensus among economists on how adjustments should be made.

Expenditure targets are politically meaningful, since the size of government is one of the central variables of the political debate in any democracy. The size and composition of public expenditure is indeed one of the clearest expressions of the agenda of any political grouping. In the absence of restrictions on the revenue side, there is no direct causal link to the debt, but most voters realise that expenditure will sooner or later have to be financed. There is some risk of countercyclical policies, but smaller than in the case of the deficit. If the fiscal rule covers only part of expenditure, however, there is a risk of a shift in spending towards categories not covered.

Restrictions on *revenue* are, of course, attractive to some political parties, particularly those that would like to limit the size of government. They affect spending, but only indirectly and with considerable time lags. There is a considerable risk that discussions on expenditure reductions are initiated too late, when a large public debt has already accumulated and freedom of action is reduced to a minimum. Whatever retreat is forced upon political decision-makers at that stage will most likely be disorderly and inefficient from the perspective of voter preferences.

Supporting procedures

As pointed out above, fiscal policy decisions are made under considerable uncertainty. Reliable information is thus a prerequisite for good decision-making, and supporting procedures of various sorts can be mobilised. Ex ante, the credibility of forecasts can be enhanced by outsourcing the production of forecasts to an autonomous institution. Transparency concerning other assumptions than forecasts made by the Ministry of Finance in the preparation of its budget documents contributes further to credibility.

Ex post, the same case can be made for evaluation. A number of countries have already created fiscal policy councils.¹⁷ Their main tasks include the independent monitoring and assessment of compliance with fiscal rules and the evaluation of various aspects of fiscal policy. Independent of the Swedish Fiscal Policy Council, the Swedish National Audit Office has initiated studies in this area in recent years.

The quality of public sector economic administration is important to fiscal policy outcomes, both in the preparatory phase of the budget cycle and in its implementation. A new approach to this complexity was the introduction of an annual assessment of the quality of economic administration in Swedish central

¹⁷ For surveys and analyses, see the website of the Swedish Fiscal Policy Council, www.finanspolitiskaradet.se/english/swedishfiscalpolycouncil/fiscalpolycouncilsabroad.

government agencies, a sort of Standard & Poor's index for central government.

2.3 Design principles

As described in section 1.2, some of the cornerstones of the budgetary reform were suggested in the 1992 ESO report and accepted almost immediately by the Parliamentary Chairman's Conference in 1993. The main changes to the parliamentary budget process were the introduction of a top-down decision procedure for the budget, the division of the budget into 27 expenditure areas and the partial rescheduling of the budget cycle to increase the importance for the Spring Fiscal Policy Bill (the government's detailed budget proposal at this time was presented the following January). When the new social-democratic government took office in the autumn of 1994, it announced its intention to continue the reform process. Negotiations in early 1995 with the centre party, which supported the social-democrats without formally going into a coalition, led to a request for some type of restriction on public expenditure – an “expenditure target” – without specifying the form or content of such a restriction.

One of the authors (Molander) suggested renaming the target to an *expenditure ceiling*, which was the term chosen by the political level. In the Ministry of Finance, work on developing a stronger system for budgeting public sector expenditure had already started at the civil servant level in early 1994. The new framework was then developed in close cooperation between the Minister of Finance and civil servants and presented to parliament by the minister in December 1995. The report, *Continued reform of the budget process*, had the approval of the cabinet *in toto*.¹⁸

The basic principles of the new budget process were fixed in the form of a handful of principles, from which operational conclusions were then derived. These principles, reproduced below, should be seen as a policy response to the fundamental problems of fiscal policy, based on an analysis of the political trade-offs to be met within Sweden's constitutional framework and political traditions.

2.3.1 The regulatory framework reflects political priorities

As stated previously, whether fiscal policy goals are reached or not very much depends on decisions at lower levels of the decision-making hierarchy, such as those by single ministers, high-ranking public officials and civil servants at grassroots level. For a program of fiscal responsibility to work, two things are necessary. Firstly, it is necessary to make aggregate political goals *meaningful* to individual decision-makers by establishing logical links between the goals of fiscal policy and the micro-level. Secondly, incentives for individual decision-makers must *harmonise* as far as possible with collective goals.

¹⁸ Molander et al. (1995).

By way of an example, consider the open-ended appropriations used in many countries for administering social security expenditure. The minister or public official responsible for the administration of such expenditure will not consider herself to be bound by an expenditure ceiling as long as open-ended appropriations are used for such transfers. Abolishing this form of appropriation was therefore one of the basic components of the reform package. As a budget restriction in no way nullifies the rights laid down in social security legislation, any conflict has to be resolved in another way. The difference with respect to the previous framework is that both political decision-makers and officials are forced to behave differently – by improving forecasts, in-year follow-up procedures and explicit political discussions once an overrun is foreseen.

A top-down approach both during the development of the budget in government offices and during the decision-making phase in parliament is a second example. There is a tendency in all budgeting systems to make decisions on future expenditure discretionary decisions because it is generally easier to agree to increase expenditure when that expenditure is not prioritised against another set of expenditures. Sector-level policy interests thus usually try to get these decisions taken as discretionary decisions.

A common characteristic of budgetary procedures in different jurisdictions is that the system aims to bring the decisions on expenditure together in one process where prioritisation is made possible. The strength of the budgetary system then depends on the balance between these two conflicting interests. The Swedish budgetary reforms of the mid-1990s created a very strong top-down and centralised decision-making process for both the overall and sector expenditure ceilings, both in the government and government offices as well as in parliament. These decisions on expenditure levels are binding and they have proven to be effective t changing incentives and behaviour among the actors at different levels of the budgetary system.

2.3.2 Parliamentary decision power is actively exercised

A number of recent fiscal policy reforms have been surrounded by an air of scepticism about politicians' abilities to restrain themselves. Such scepticism often takes the form of automatic rules, reducing parliamentary decision-making in times of crisis to a confirmation of past decisions. By contrast, the Swedish reform package relies heavily on the ability of policymakers to make sound judgements, assuming i) that an adequate institutional framework is in place and ii) that the relevant facts are presented in an accessible way. The Swedish constitution, as do most constitutions, unequivocally assigns fiscal policymaking powers to parliament, both on the revenue side (exclusive right of taxation) and on the expenditure side (parliament decides on the use of public resources). There is reason to believe that the design of the new budget process explains the strong support among Swedish policymakers for the budgetary framework.¹⁹

¹⁹ As testified recently by a senior IMF official during an Article IV consultation in Sweden.

Some critics of the Swedish reform have claimed that it leads to decisions that lack democratic legitimacy since in their view the decision-making process has taken powers away from elected politicians and given them to “technocrats” or has led to decisions that occur “automatically” as a result of expenditure ceilings. We do not share this view. On the contrary, political institutions can at any time decide to change both the general and the 27 sector-level expenditure ceilings, as is clearly stated in the reform. Governments and parliaments of different political orientations have not decided to use this opportunity because they have seen important advantages in maintaining previously decided expenditure levels and reprioritising within the existing expenditure ceiling when priorities have changed due to either new developments or changes in political orientation. The politicians responsible for general economic policies and public finances in general are supportive of the current budgeting system following from the 1997 reform. This is also true for almost all political parties, including party leaders and other high-profile politicians, not just those directly responsible for economic policy and public finances.

When the budgetary reforms were discussed and prepared in the Ministry of Finance, there was strong belief among both the politicians and the civil servants involved that a budgetary system would only be effective and enduring if it had political legitimacy. The intention was never to create a system that moved decision-making powers away from democratically elected politicians. The approach was instead to strengthen the role of those political office holders, in parliament and in government, who were overall responsible for economic policies and public finances. It is our view that the main reason that the new budgetary system has been effective for almost two decades is precisely this approach. A system based on expenditure decisions taken with some kind of automaticity, and in a certain sense in conflict with the political system, would almost certainly not have survived as long.

2.3.3 Independence of the technical form of financial commitments

No system of budgetary restrictions is foolproof. There is always some method of circumventing restrictions, but such attempts can be made more difficult if adequate rules are in place.

An obvious way to evade an expenditure restriction is to formulate a subsidy on the revenue side of the budget in the form of a tax deduction. One could try to prevent this from happening by introducing a rule that prescribes a modification of the expenditure ceiling if such subsidies are introduced, but this presupposes that a system of tax expenditure accounts is in place. This was seriously discussed when the reform was prepared in the Ministry of Finance. The conclusion was that it would have been complicated to find a solution, and that such a solution would have made it more difficult to reach political acceptance for the reform. It was not evident that such rules concerning *tax expenditures* were necessary since the Minister of Finance, responsible for adherence to expenditure ceilings, is also responsible for tax policy and tax legislation, whose ministry has the foremost expertise on tax matters and who has the prerogative of making proposals to the government in this area.

A second example of circumventing budgetary restrictions is to use government guarantees as subsidies in disguise by not collecting fees that are adapted to the risk level of the insurance in question. The appropriate countermeasure in this case is a system of actuarially computed insurance fees and an agency entrusted with the task of levying such fees.

Over time, the skills to circumvent the rules increase. Our view is that the solution is not increasingly detailed rules but rather, firstly, clear principles that have strong political support and, secondly, well-functioning systems for the forecasting and follow-up of expenditure developments. If rules become detailed, there will be need for exceptions, which may, in fact, make breaching the rules easier. As the system becomes technically complex, it also becomes more difficult for political institutions to play their fundamental role as guardians of the system.

2.3.4 Improved decision support, increased transparency and the completeness of budget documents

The goal of improved transparency is achieved through a number of concrete measures. One central principle is the completeness of the budget, i.e., that all expenditure is registered on the budget to make sure that all expenditure is assessed in the process of prioritisation. During the preparation of the Swedish budget reform, many suggestions were made to exclude certain types of expenditures (social security and the labour market fund were the most important) from budgeting rules. Another important principle is to ensure gross budgeting, so that some categories of spending do not escape the prioritisation process because expenditure and revenue are netted. Any budgetary system, particularly one based on expenditure ceilings, needs high-performing in-year follow-up procedures so that potential overruns can be addressed through political decisions either to reduce expenditure or to reallocate resources from other areas. Even if expenditure ceilings do not directly include the consideration of tax expenditure, it is still important for the completeness of the political process that decisions on taxes and revenues are part of the same political process and that they are summarised in a transparent way in budget documents. Although not directly linked to expenditure ceilings, the high-quality evaluation of expenditure programs is also still important for a well-functioning prioritisation process.

2.3.5 Fostering long-term perspectives

The time-inconsistency problem calls for institutions that prolong the time perspective of decision-makers beyond the next budget year and hopefully even further when it comes to long-term problems concerning, for instance, demography, education and pensions. By contrast, a new government taking office must be free to shape its own fiscal policy, so a trade-off problem arises here.

This political problem is solved simply by giving any government (as well as the incumbent) the formal possibility to change the expenditure ceiling at any time. This solution can be perceived by some as creating uncertainty and

weakening the system, but there is considerable cost associated with raising the ceiling. Within the political system, there will be those, in all parties, who prefer at any moment to increase expenditure to meet political priorities and those who will resist in order to make sure that public finances are kept in good shape. This difference of opinion should be played out in political institutions as well as inside political parties. The important aspect is how the framework balances the powers of these different interests. The budget system in Sweden following the 1997 reform has clearly moved the balance more in favour of those political functions whose role is to safeguard sound public finances, which was the political aim following the experience of two serious crises in public finances during the preceding two decades.

The choice of horizon for multi-annual expenditure ceilings in practice boils down to three, four or five years. The three-year horizon was chosen mainly because of the general uncertainty of economic forecasts and because it was considered wiser to prolong if appropriate a three-year period than to be forced to roll back a longer period considered to be unmanageable.

When the new budgetary framework was first used in 1996, the strongest binding general restriction was the central government budget balance for 1998. The time horizon problem was addressed a second time when the surplus target for the entire public sector was introduced in 2000. The target was based on a structural deficit approach, requiring that the computation of structural balance be specified.²⁰

The link between the surplus target and expenditure ceiling is strong. The expenditure ceiling can be chosen freely (as long as revenues are kept in line with the surplus target) and is consequently neutral with respect to fiscal policy preferences. Rephrasing Immanuel Kant's well-known dictum on theory and experience, budgetary institutions without a medium-term budget balance target are blind, but medium-term budget balance targets without strong budgetary institutions are empty. In this context, it is important to note that while targets for the budget balance are clear and often politically convincing, they are difficult to make operational. They tend to become important once a problem occurs but are, in our view, weak instruments for avoiding the occurrence of public sector imbalances.

2.4 Technical solutions

Technical solutions will now be discussed in somewhat more detail against the backdrop of the trade-off problems mentioned earlier.

2.4.1 Components

Top-down budgeting procedure

Parliament adopted an orthodox top-down budgeting procedure in its decision in 1994. Starting from fiscal policy goals at the aggregate level, parliament

²⁰ Boije et al. (2010).

decides on the budget in a two-step procedure. The first decision comprises the budget total and limits for each of the 27 expenditure areas into which the budget is divided. These 27 expenditure areas have been relatively stable since their introduction and, while they often follow boundaries of ministries, there are quite a few exceptions to this. The figure, 27, is of course not important *per se*; what is important is that the budget is partitioned into manageable and reasonably homogeneous slices that can be discussed in more detail by parliamentary standing committees. This discussion, leading to the second decision that fixes the budget at a detailed level, is led under the restriction of the first decision. In essence, this means that any increase in expenditure that would break the expenditure area ceiling must be offset somewhere else in the same expenditure area. In this way, the natural tendency towards expansion is balanced locally by each standing committee.

Two things should be underlined here. Firstly, the top-down decision procedure derives its legitimacy from the fact that parliament decides itself on the limits imposed, although they are, of course, proposed by the government. Even if supranational restrictions relative to the EU framework form part of the background, parliament is autonomous in its decision-making. EU restrictions on public sector deficits have played no role, since the Swedish budget balance policy, which demands surpluses over the economic cycle, is stricter.

Secondly, and equally important, no fiscal policy is implicitly built into the top-down framework. It is well known²¹ that although top-down and bottom-up procedures may clearly lead to different outcomes, there is no implicit bias towards lower spending levels in the former. This can be illustrated by the following simple example. Assume that there are three roughly equally sized parties in parliament and that the situation is such that the median voter is decisive. Further, assume for simplicity that the budget contains only two items, social welfare and defence, and that the preferred budgets of the three parties are expressed in a suitable budget unit (Table 1).

Table 1 Voting in parliament with three parties represented

	Party A	Party B	Party C
Social welfare	70	45	30
Defence	30	45	40
Total	100	90	70

A top-down procedure would yield 90 budget units, assuming that the parties vote in accordance with their preferences, whereas a bottom-up procedure would yield a social welfare budget of 45 units and a defence budget of 40 units, adding up to 85 – less than the alternative outcome.

²¹ McCubbins and Schwartz (1985), Ferejohn and Krehbiel (1987) and Helland and Rasch (1996).

The top-down approach is not only applied in parliamentary decision-making; it also permeates the preparation of the budget in government offices. After a relatively long preparatory phase, a preliminary budget proposal is sent from the Minister of Finance to the other members of the cabinet. This proposal is consistent with the overall budget restrictions and is the default alternative in discussions within the cabinet. The same offsetting rules as in parliament also apply during this internal process in the government.²²

Expenditure ceiling

The expenditure ceiling is nominal, tri-annual and covers all central government expenditures except interest on central government debt. It includes the pension system, over which the government has full authority, but it is not binding for the municipal and regional sector (see below). The time horizon, three years, was justified above. The nominal character was the subject of intensive debate during the reform, but it was strongly supported by the Prime Minister and Minister of Finance and finally accepted. There is reason to believe that this choice contributed to reducing the rate of inflation. As it turned out, the target rate (2 per cent) in fact created extra room for manoeuvre, because the actual rate of inflation was lower during the early years following the reform.

Concerning coverage, there were three strong reasons for excluding interest payments. Firstly, interest payments are not politically decided but are the result of already accumulated debt and commercial transactions between the state and other contracting parties. Secondly, this was at the time of reform the single largest item on the budget, which – thirdly – combined with its volatility made it difficult to manage under the ceiling. The municipal sector was excluded for reasons of local autonomy, but Swedish municipalities have traditionally balanced their budgets in any case. A law on local government budget balance was adopted by parliament simultaneously with the reform, and this has since proven to be very effective.

There was also discussion on the inclusion of certain large entitlement programs, such as unemployment benefits, labour market policy programs and sick-leave insurance, and the decision was to include them so that the needs in these areas were prioritised in relation to those in other expenditure areas. It is, in our view, almost certain that the new budget system would not have functioned well if those expenditure areas had been excluded. This, of course, is not at all to say that expenditure levels for entitlement programs should be arbitrarily limited, only that the allocation of total public expenditure should be decided in a common process, while total expenditure level should be based on general political priorities in combination with the political objectives set for the budget balance, including tax and revenue policies.

The expenditure ceiling also includes a budget margin. The simple justification for this component is forecasting uncertainty. The margin was originally set to

²² For general experiences of top-down approaches, see Ljungman (2009).

1.5, 2, and 2.5 per cent for the three years of the ceiling, respectively. The budget margin is discussed further in chapter 5.

Appropriations

Because open-ended appropriations were incompatible with an expenditure ceiling, they were abolished. Abolishing this type of appropriation, however, did not eliminate the potential conflict between legally based rights and budget restrictions, and thus some sort of behavioural modification was required. What the restriction implies is that the agency in charge of an appropriation for which an overrun is foreseen has to write a formal letter to the government announcing the problem and asking for more money. This triggers a discussion within the government on the appropriate measures to be taken. Depending on the size of the overrun, it can be met within the same expenditure area or within the domain of responsibility of the ministry engaged (assuming it controls more than one expenditure area), or it may trigger a budget-wide discussion involving the whole cabinet. The budget act authorises the government to spend up to 10 per cent more on an individual appropriation than decided in the budget for the particular purpose in question; if the overrun foreseen is larger, a new parliamentary decision is necessary. In both cases, the global expenditure ceiling and expenditure area ceiling have to be respected; indeed, in the first case, parliament will be informed by the time of the next budget bill (spring or autumn) at the latest.

Completeness

The basic rule is now that the central government budget is based on the gross budgeting principle, that is, no netting of expenditure against revenues is allowed.

Tax expenditures

Because the expenditure ceiling is vulnerable to creative bookkeeping on the revenue side of the budget, transparency with respect to tax expenditure is necessary. Tax expenditure accounts were already being prepared before the reform,²³ but they became particularly useful in its wake. A general tax expenditure account collects all deviations from standard tax rates in the form of exemptions, deductions and so on. From the perspective of fiscal policy management, the absolute level is less important – changes from one year to the next should be the focus of attention. When restrictions are imposed on the expenditure side of the budget, there is, of course, an increased temptation to use tax expenditure in order to evade these restrictions while promoting certain political goals. A possible countermeasure would be to adjust automatically the expenditure ceiling for changes in the level of tax expenditure. This was discussed but not implemented during the reform because of the lack of precision in computing this level. Instead, tax expenditure is presented in a detailed account together with the Spring Fiscal Policy Bill.

²³ Mattsson (1992).

Improved forecasting and follow-up

The dismantling of open-ended appropriations and establishment of the expenditure ceiling generated intense interest in improved forecasts both in agencies and in ministries. This was supplemented by comprehensive the in-year monthly follow-up of expenditures relative to budget figures, something that had somewhat surprisingly been lacking in the Swedish budget system.

Performance measurement

Simultaneously with the reform, efforts were made to improve performance measurement, aiming at a comprehensive set of indicators. This work was carried out independent of the budget reform and it continued several years after the new system has been put in place. It is important to realise that performance measurement and management is not a means for controlling budget deficits. It may help improve productivity, but productivity increases are not automatically translated into savings on the expenditure side of the budget.

Budget cycle

The new annual budget cycle, based on the calendar year, represented an improvement. Coordination with national accounts was facilitated, which simplified forecasting. Decision-making during the autumn session on the budget for the following year sometimes appears strained but manageable. A special timetable is now applied in election years, as elections are always held in September.

The new timetable in some senses moved the centre of gravity from autumn to spring. The cabinet meeting in March/April, based on a Norwegian model, became important for anchoring the fundamental priorities in the circle of ministers. At this meeting, only ministers plus the state secretaries supporting the Prime Minister and Minister of Finance participate, implying that each minister has to learn the important basic facts and arguments pertaining to his or her domain of responsibility. There is reason to believe that this format instils a sense of responsibility for the general budget among ministers. Furthermore, the consensus established on the basic parameters of the budget at this early stage of the budget cycle helps stabilise the detailed budget negotiations that follow and the posture of the government to the world outside. These changes have to some extent been reversed, in our opinion for the worse (see section 5.5).

Rating of the agencies

In Sweden, the bulk of the administrative resources in central government are found in agencies. For this reason, the competence of agencies is fundamental to the implementation of the budget. As part of the reform package, the economic/administrative rating of these agencies was therefore introduced. This rating is based on a questionnaire answered by the agencies that results in a sort of Standard & Poor's index of economic reliability. The National Financial Management Authority is in charge of the rating procedure and this body checks for the correctness of the data delivered. The since published

figures have resulted in a steady improvement in the administrative and economic capacity of agencies.

Strengthening the position of the audit office

At the time of the reform, the National Audit Office was an agency under the government and not under parliament, as is normally the case. In order to strengthen its position compared with the agencies inspected, the government introduced a new section in the Budget Bill under the heading, “Measures taken on account of the annual audit reports”. This was completed in 1994 and it became an important supporting element in the reform. In 2003, the National Audit Office was reorganised to become an agency under parliament.

Budget act

A budget act, specifying the freedom of action of government vis-à-vis the parliament in the fiscal policy area, was written in 1996 and took effect on 1st January, 1997. The act summarises the main building blocks of the reform and comprises a number of rules on the buying and selling of government property. The use of the expenditure ceiling was left as an option in the initial formulation but it is now mandatory.

Accounting principles

There is long-standing debate on the pros and cons of accrual accounting, and transition to accrual accounting was discussed in the preparation of the reform. In Sweden, both budgeting and accounting in agencies is accruals-based, whereas the central budget represents a hybrid between a cash basis and a modified accruals basis. This creates some mismatch when agency budgets are consolidated into an annual report for central government, but the problem is manageable.²⁴

Evaluation agencies

Independent of the budget reform, Sweden has developed a structure of autonomous inspection and evaluation agencies in a number of sectors, such as crime prevention (Brå), labour market policy (IFAU), transport (first Sika, now Trafikanalys), development aid (Sadev) and social insurance (ISF). These agencies, working at arm’s length from the government offices, help strengthen accountability by acting as autonomous sources of information about the state of the public sector and knowledge about the outcomes and mechanisms at work. They also strengthen the government offices vis-à-vis large administrative agencies, which traditionally, in Sweden’s particular administrative structure, have maintained a strong position in relation to the government.

²⁴ See Lindqvist (2001).

2.4.2 Relationships with the fundamental problems of fiscal policy

Each of the building blocks of the reform can be considered to be a response to one or several of the fundamental problems of fiscal policymaking described in section 2.1. Table 2 summarises the main connections.

Table 2 Relationship between the fundamental problems of fiscal policymaking and the institutional remedies applied in the Swedish reform

Fundamental problem of fiscal policy	Institutional remedy or solution
<i>Aggregation of preferences</i>	Top-down approach to budget preparation and decision-making Larger aggregates (expenditure areas)
<i>Common pool problem</i>	Top-down approach Expenditure ceiling Dismantling of open-ended appropriations Increased transparency: - completeness of budget proposal - tax expenditure accounting - new system of guarantees Supranational norms (Maastricht Treaty) Strengthened accountability: - financing counterproposals - managing overruns Financial inquiries, decision support (forecasting etc.) Nominal expenditure ceiling
<i>Time inconsistency</i>	Multi-annual expenditure ceiling Surplus targets New system of guarantees
<i>Principal-agent problems</i>	Budget act Internal audit Economic/administrative rating of agencies Strengthening of National Audit Office Evaluation agencies: Brå, IFAU, Sika (Trafikanalys), Sadev and ISF

3 Factors behind successful reform

3.1 Window of opportunity

It seems to be generally true in advanced economies that the reforms of processes determining public finances are embarked on when there is an acute crisis in the form of untenable levels of or the outlook for public sector deficits or debt. However, this is not a sufficient condition for reform. As already mentioned, Sweden went through serious public finance problems in the late 1970s and early 1980s, but this did not lead to any significant changes in the budgeting procedures. The reason for this is probably that measures to deal with fiscal imbalances, in combination with large depreciations, led to a rapid improvement in public finances, and the conclusion was that the problem had been resolved. This was followed by a new build-up of fiscal imbalances masked by an economic boom and by the effects of a real estate bubble. Only when serious public finance imbalances resurfaced in the early 1990s was a serious reform process initiated.

The integration of the Swedish economy in the world economy, particularly in global financial markets, had by then gone much farther. This and the prospect of Swedish membership of the EU may have had some influence on the decisions made, but there are two other equally important reasons why the Swedish political system was willing to embark on a major reform of the budgetary process in the early 1990s. One reason was that the situation was substantially more serious in the early 1990s than it was in the late 1970s. More importantly, the “solution” to the public finances crisis a decade earlier did not last. It was obvious that it was not enough to limit the decisions to sorting out the ongoing crisis; strengthening the processes was also necessary.

3.2 Reform climate

As in many other countries, Sweden had gone through a rapid and successful modernisation program after the Second World War with high growth rates and the rapid expansion of the public sector. In certain respects, particularly trade, the Swedish economy was very open to the outside world. In other respects, it was quite closed, e.g., concerning capital movements. The 1980s saw a range of reforms in different areas. The tax system was radically changed in the late 1980s, leading to more homogeneous taxation based on wider tax bases and lower rates, particularly lower marginal tax rates. Financial markets, which had previously been highly regulated, were also substantially deregulated. Preparations for a reform of the pension system started in 1984, and these were implemented in 2000, creating an economically stable pension system. In other important areas for economic performance, reforms were also put in place, e.g., the dismantling of textile quotas, while an agricultural policy reform removed most internal market regulations. One last example is that the policy of substantial subsidies to parts of the industrial sector (e.g., shipyards), which had been introduced at the time of the economic crisis in the second half of

the 1970s, was dismantled. The reform of the budget process in the mid-1990s was consequently taking place against the backdrop of policy reforms in other areas of importance to the Swedish economy.

3.3 Geometry of interest groups

Any significant reform will meet with resistance from groups who rightly or wrongly believe that they will lose from the changes envisaged. The type and structure of the resistance met will depend on the character of the reform. An agricultural reform initiative has to confront a small but well-organised and vociferous interest group. A budget reform proposal, by contrast, meets with broad but diffuse resistance or scepticism. These two situations have to be managed differently. As indicated in the previous section, it may, somewhat paradoxically, be easier to go ahead with several reforms simultaneously, thereby creating a general climate of reform and neutralising the objections from different interest groups.

3.4 Basis in empirical research

An important factor for the success or failure of a reform project is what empirical research results are available at the time of the reform. The situation differs between sectors: agricultural policy is very well supplied with research analysing the costs and inefficiencies of agricultural policy, whereas labour market policy is less so. Fiscal policy and institutional economics in the early 1990s represented an intermediate case in this respect, as should be clear from the literature cited in this paper.

In the Swedish Ministry of Finance Budget Department, there had been limited use of academic research findings in the development of budget policies and systems. This was changed in the early 1990s when resources were devoted to analysing and operationalising academic findings, such as those presented by von Hagen. Without this solid basis of academic research, it is likely that the reform proposals would have been of poorer quality and the arguments less convincing.

The way the work on the reform process was organised differed from the methods used earlier. A specific unit was created in the Budget Department with the task of developing economic management methods at all levels. This unit was only marginally involved in the time-consuming and difficult annual budget negotiations. The long-term project was thus protected from serving the short-term needs, which provided the possibility to develop a thoroughly considered and wide-ranging proposal.

3.5 Entrepreneurs

It seems as though a necessary condition for a reform process to be successful is a small group of politicians and experts strongly committed to it. Experts are necessary for the analysis and development of technical and administrative solutions. However, in the absence of a strong political commitment to change the system, very little can be achieved (as should be the case). Politicians establish a general orientation for reform decisions and, of course, give

credibility to the reforms. It is also important that reforms are supported by politicians in parties from the opposition. In fact, political disagreements on the reform of Sweden's budgetary process were rather within the political parties, particularly between the politicians responsible for economic and fiscal policy and those responsible for important public expenditure sectors. The situation and methods used were similar in the other reforms cited in section 3.2.

The reform process started among the civil servants in the Ministry of Finance. The background was a sense that the Swedish budget system was too weak, as confirmed when von Hagen's analysis was applied to the Swedish system. The intention of civil servants was to be able to present to the political leadership a well-developed and detailed outline of a possible reform for them to assess and decide on. The appreciation by civil servants of the needs proved to be correct. At the highest political level, there was real concern that the budget process was insufficiently strong to achieve sustainable public finances. The civil servants in the Ministry of Finance were thus asked to pursue their work, from then on performed in close contact with the political level.

It is also worth noting that there may be an important degree of conservatism in any organisation. Although the reform of the budget process is now strongly supported by most experts and politicians, a number of both the political advisors and the civil servants in the Ministry of Finance at the time were sceptical. Many considered the reform too far-reaching, particularly the inclusion of expenditure in the areas of labour market policy and social security (which relied on open-ended appropriations). A more modest reform excluding these areas from the expenditure ceilings would most likely have been unsuccessful, however. Interestingly, the politicians at the highest level were supportive, which of course was a necessary requirement for the reform. The Minister of Finance at the time, in internal discussions, expressed it thus: "Expenditure ceilings are introduced not as a dead hand over expenditure, but in order to take a firm (political) grip on them."

3.6 Making the case for the reform

Generating political acceptance takes a strong pedagogical effort. Different reforms are more or less difficult to explain. Tax reforms are difficult, because persons who lack economic training do not immediately see the difference between taxes and other methods of financing. The concept of the *excess burden of taxation* is difficult to explain.

Fiscal policy is somewhat easier. Everybody realises that a government cannot in the long-run spend substantially more money than it receives via taxes and other revenue sources. The vast majority of citizens in Sweden agree that public resources should be used judiciously and that permanent deficits and a large and growing public sector debt are potentially very dangerous.

In the context of explaining a reform to the public, it is necessary to assume full responsibility for the choices made and not to blame external forces. The latter alternative may seem to be attractive in the short-run but it is liable to creating unstable results when reform decisions are later questioned.

The Swedish reform of the budgetary process was never presented as something imposed from the outside such as the EU or financial markets. During the period of large fiscal deficits, Sweden was clearly dependent on international financial markets, but this was turned into an argument in favour of reform: Sweden had a fundamental interest in strong public finances in order to regain autonomy. Other positive arguments were:

- Strong public finances contribute to good economic development with higher living standards and higher employment.
- Stable public finances reduce the risk of economic crises and strengthen Sweden's capacity to overcome such crises emanating from the international economy.
- Public resources are limited, and a better system for prioritising among public expenditure alternatives is in the interests of citizens.

There are strong reasons for the view that a reform of the budget process should be based on positive arguments describing the favourable effects that it will produce. A negative set of arguments based on threats and a sense of forced conversion in response to outside demands would almost certainly have been counterproductive.

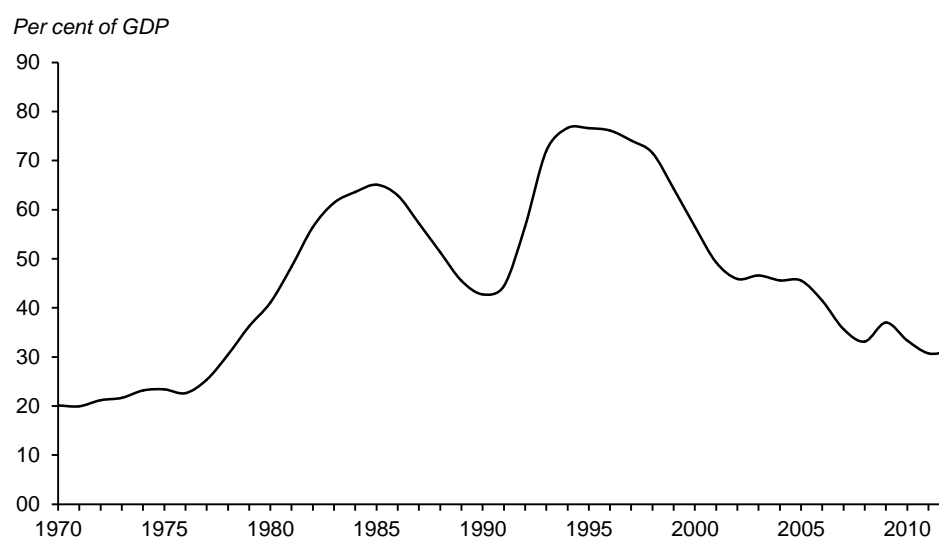
4 Evaluation

A full-scale evaluation of the budget reform is beyond the scope of the present report. It is indeed difficult to imagine a full-scale evaluation of any single institutional reform of this kind, given the complexity of causal links involved. The sections that follow simply highlight a number of dimensions where the reform is likely to have had significant impact.

4.1 Consequences for Sweden's public finances

The immediate effect of the reform was that the government regained control over public finances and that central government debt first ceased to grow and then started to decrease rapidly. The development is illustrated in Figure 6.

Figure 6 Development of the central government debt 1970–2012



Source: ESV.

It is not claimed that the entire reduction in central government debt can be ascribed to the institutional reform. Indeed, the direct effect of an institutional reform is normally zero. Institutions work indirectly, by making certain choices more likely than others, and reforms in this area will therefore have visible consequences only in the medium to long run. In order to regain fiscal balance in the short run in the early and mid-90s, it was of course necessary to make a number of decisions concerning both expenditure and revenue aggregates – public consumption, remuneration rates in social security benefits, tax rates, etc. It is nonetheless reasonable to assume that the effect of such measures in the absence of an institutional reform would have been both more limited and more short-lived.

According to von Hagen's estimate, the improvement in the structural index corresponds to a reduction of central government debt by approximately 30 per cent of GDP, or 1000 billion SEK. This in turn reduces interest payments by about 20 billion SEK annually at the current (low) interest rates. The total

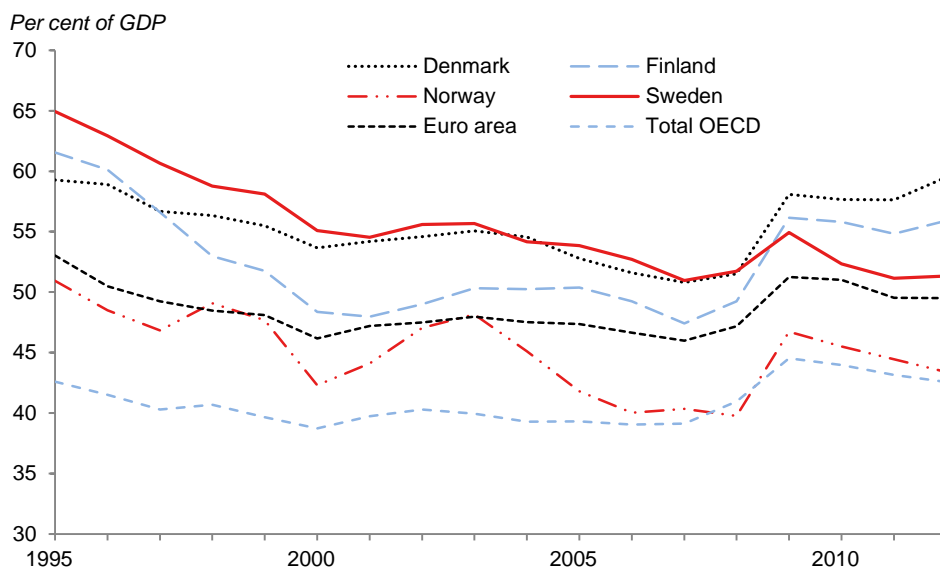
reduction in central government debt during the last 20 years according to the figure is between 45 and 50 per cent of GDP. In other words, about two-thirds of the long-run effect on the debt could reasonably be ascribed to the reform.

4.2 Macroeconomic consequences

The evidence on the relationships between indebtedness, on one hand, and stability and growth, on the other, is somewhat mixed. Using nonlinear models, Egert has detected negative effects on growth at rather low levels of indebtedness, between 20 and 60 per cent of GDP.²⁵ Whatever the relationship between debt and growth, however, Sweden's economy was back on track after a few years and it has remained relatively stable since in comparison to other OECD countries.

Another macroeconomic change is that the public expenditure ratio has been successively reduced. Two things should be stressed in this context. Firstly, as pointed out earlier, there is no inherent fiscal policy in the new fiscal framework. If the expenditure ratio has gone down, it is because the political majority has chosen this development. One important factor, but certainly not the only one, behind this development is the non-indexed nature of social security expenditure. The generosity of social insurance has decreased successively as a result of a number of non-decisions, resulting in an overall level that is near the average among the group of OECD countries that Sweden traditionally compares with. Secondly, the link between expenditure and macroeconomic performance is weak, and thus there is no case for claiming that enhanced economic growth is the reason for the reduced expenditure ratio (Figure 7).

Figure 7 General government expenditure in Sweden 1995–2012



Note: Forecast for the final year.
Source: OECD.

²⁵ Egert (2012).

The stability of the financial system has also increased since the crisis of the early 1990s. The main reason for this is that Sweden has learned how to manage a crisis through bank guarantees, a system of reconstruction for banks that actually failed, while sound public finances help increase confidence in the ability of the government to actually implement efficient policy.

4.3 Political consequences

Sweden's strictly proportional voting system easily leads to a fragmented political situation in parliament. As a consequence, forming a majority government normally requires a coalition; in the post-War period, the only time when one party succeeded in gaining a majority of its own was when the social-democrats won the election in 1968. From that perspective, it is important that the new budget procedure based on top-down approach has significantly improved the situation for minority governments. The reason for this is that it is now easier to get a budget proposal relatively unscathed through parliament. In order for a majority opposition to block the government's proposal, it must unite on a coherent alternative, which is difficult. The government may lose votes on single appropriations, but this is less serious both politically and financially.

Having said that, a minority government may strive at a broader base in parliament for macro-political reasons; there is more to governing than getting a budget accepted. This is why the Social-Democratic party has chosen to liaise with the Centre Party and the Green Party during different electoral periods, although it was probably not necessary in order to gain the parliamentary approval of the government's budget.

4.4 Constitutional consequences

Almost all political parties in Sweden support the reformed budget process, but some commentators criticise the reform for having created a technocratic system with less room for manoeuvre for political decisions. We do not share this view, and the vast majority of politicians seem to agree with us. The aim of the reformed budget process was to give the politicians in parliament and the government improved possibilities, firstly, to decide on both the level and the allocation of public expenditure and, secondly, to avoid financial crises of the type experienced during the two decades preceding the reform. Politicians from different political parties and of different ideological orientations seem to agree that the possibilities to exercise political control over public finances have been much improved and that this is a crucial benefit of the reform.

The balance of power between the government and parliament very much depends on the support for the government in parliament. If the government has guaranteed majority support in parliament, then parliament is less influential than when the government only has guaranteed support from a minority of parliamentarians. Whatever the effects of the new budget process on the balance of power between the legislature and executive branches of government, the important change in our view is the changed balance of power within these two branches. The bodies responsible for economic policy

and overall public finances – the Standing Committee on Finance in parliament and the Minister of Finance in the government – have seen their powers strengthened. The same can be said about the Prime Minister as well as the leadership of the political parties, since prioritisation among political alternatives has been facilitated to the point of even becoming necessary.

5 Further improvements

5.1 Increased flexibility

As repeatedly stated, the central trade-off in the design of any budgetary framework is choosing an appropriate level of flexibility. During the 15-plus years of its existence, the central building blocks of the reform have not been seriously questioned, but there has been some creative bookkeeping at the margins. If one perceives this as a threat to the credibility of the budget process – which is open to debate – there are two ways to resolve the conflict in an acute situation: raise the ceiling for clearly stated reasons or have a larger budget margin at one's disposal from the outset.

At the same time, one should note that in every budgeting system there will be at least some opportunity to use creative bookkeeping. A system that completely eradicates this possibility will almost certainly be so inflexible that it is unlikely to survive. The criterion should rather be to limit such opportunities so that they do not lead to significant problems.

5.1.1 Raising the ceiling

The value of the ceiling is determined by the way in which it is used. Obviously, it cannot be changed too often if credibility is to be preserved. In Sweden, this consideration has led governments to maintain the ceiling once established. On one occasion, it was lowered. However, a new government taking office should have the opportunity change the ceiling in any direction as an expression of its political priorities. If this has been announced during the election campaign together with other appropriate economic policy actions – for instance, changes in taxation – the negative effects on credibility should be limited.

A number of countries have introduced escape clauses in order to cope with contingencies.²⁶ Such clauses typically refer to extraordinary financial situations or natural disasters. The category of extraordinary situations is likely to be abused, and invites lax financial policies. Natural disasters, by contrast, may represent important traumas to a nation but they are in most cases unimportant from a budgetary point of view; the tsunami of 2004 is a case in point. War or warlike conditions are of course different, but these demand important changes in many areas including the budgeting system.

5.1.2 Increasing the budget margin

The budget margin was originally designed as an instrument to cope with forecasting uncertainty. In a previous report by the Fiscal Policy Council,²⁷ two objectives were stated: forecasting uncertainty and uncertainty about political

²⁶ Schaecter et al. (2012).

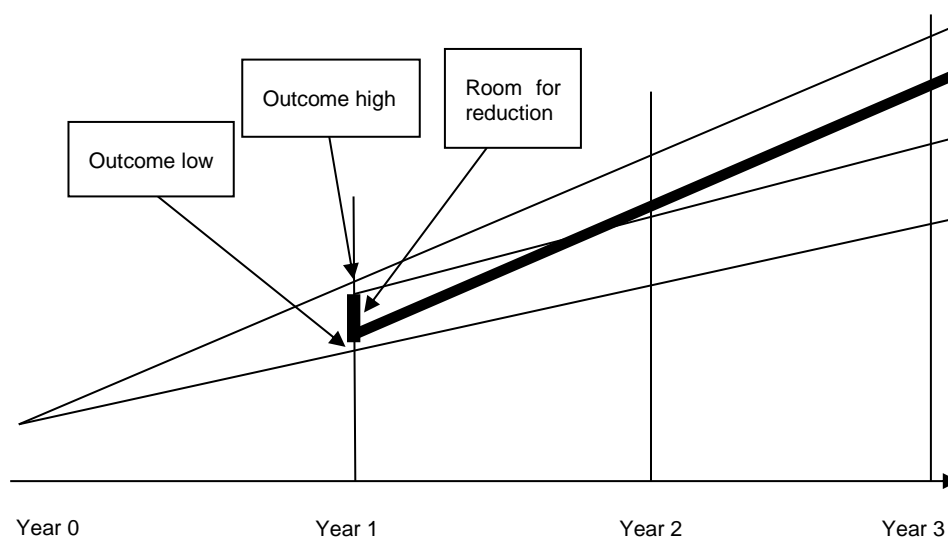
²⁷ Swedish Fiscal Policy Council (2010), p. 124 f.

reforms. The latter category seems to be somewhat strange. If there is anything that a government is in control of, it is political reforms. Such reforms should ideally be planned and announced as early as possible. This seems to be a weak argument for increasing the budget margin.

As for forecasting errors, the Fiscal Policy Council has suggested that this part of the margin be divided into a business cycle component and a residual component. This also seems to be a questionable suggestion. Most business cycle-induced variations in the budget appear on the revenue side – about three-quarters according to rule of thumb.²⁸ Further, business cycles are notoriously difficult to forecast. This represents a problem for the surplus target, but here the problem is manageable, because we are dealing with *ex post* averages over a long period. Since the effects of the business cycle are difficult to compute, it is likely that the introduction of such a component in the budget margin would lead to more options to avoid political choices, that is, contrary to the aim of expenditure ceilings. Computing the effect of the cycle for a single year requires a much higher degree of precision, which current models cannot deliver. The question also arises which appropriations should be included. Many different types of appropriations are affected to some extent by the business cycle. For instance, we know that annual fertility figures are affected, but this does not necessarily imply that the appropriation for child allowances should be recomputed.

If there is a strong need for increased flexibility, the least harmful solution may be to increase the budget margin in order to account for the use of it *ex post* and lower the margin (and, consequently, the ceiling) to the extent that it has not been necessary to use it. The appropriate method was sketched by Molander and Paulsson (2008) (see Figure 7).

Figure 7 Management of the budget margin



Note: If the outcome is high, the original expenditure ceiling remains unchanged. If the outcome is low, there is room to reduce the ceiling.

²⁸ Lindh and Ljungman (2007).

If the outcome is high, the reason is somehow linked to the business cycle. This will affect whether the budget is in accordance with the surplus target when compatibility with this target is checked *ex post*. If the outcome is low, there is room to reduce the expenditure ceiling. In any case, the use of the budget margin should be detailed in the budget as soon as the figures are available, that is, in the Spring Fiscal Policy Bill.

5.1.3 Computing the surplus target

There has been considerable discussion about the evaluation of the medium-term surplus target. The computation of the structural deficit is complicated by the fact that it is difficult to determine the status of the economy with respect to the business cycle. Boije et al. (2010) suggested that the evaluation of the surplus target be based on a 10-year moving average. We endorse that proposal.

5.2 Tightening remaining loopholes

As repeatedly stated, there is no fool-proof system of accounting. The question naturally arises whether there are any remaining loopholes in the present system that ought to be tightened. One candidate is to recompute the expenditure ceiling in order to compensate for tax expenditure reforms. The reason is that so far this is the numerically most important deviation from the spirit of the reform. The computation of tax expenditure can be difficult because behavioural effects may be involved, but an honest assessment is in any case better than setting the effect to zero. As mentioned, the fact that the Minister of Finance is responsible for both budget and tax policy substantially reduces the need for a tax expenditure ceiling.

5.3 Sanctions

A fundamental weakness of the budget act (as with virtually all administrative laws in Sweden) is the absence of sanctions. The budget act specifies the freedom of action accorded to the government by parliament. What if the government violates these restrictions? The standard answer to this form of objection is that sanctions in this field are political; the ultimate sanction is that the government is ousted from power. As a sanction against a violation of a specific rule, this is woefully inadequate, however. A voter may support the general policy of a certain political party or coalition while still being interested in pursuing violations of important rules. We do not accept general assessments when individuals have committed crimes; it is the single act that should be judged and punished irrespective of what good deeds the individual in question is capable of. Obviously, this question has to be settled within a broader discussion about accountability in the public sphere, and we refrain from putting forward proposals for this particular case.

5.4 Codifying parliamentary voting rules

It is highly unsatisfactory that important voting rules in the Swedish parliament are not codified but rather based on practice only. When there are several

proposals to be voted on, the parliamentary working order prescribes successive elimination as the method to use. The proposals coming from the opposition are voted first in order to single out the strongest opposing alternative to the government proposal. The final vote positions the government proposal against this opposition proposal. According to tradition, an opposition party that has lost in an early vote abstains from further voting. This makes it possible for a minority government to get a proposal through parliament. In Norway, by contrast, voting is mandatory all the way through. This creates a very different situation.

When a new party entered the Swedish parliament after the election in 2010, it considered itself free from this tradition, which created problems for parliament's decision-making process. This was caused by the lack of regulation, and can consequently be handled by codifying what has hitherto remained tradition. Consider an example where in parliament, the government block controls 45 per cent of the votes, the main opposition block 40 per cent and a politically marginal party 6 per cent. The smaller party has a pivotal position due to the uncertainty about where it will place its votes once its own proposal has been voted down. If voting is mandatory as in the Norwegian parliament, government-supporting MPs may choose to support the proposal from the marginal party in the conviction that the main opposition block would never vote for that alternative in the final vote. A different alternative would be to give each party only one vote, which amounts to codifying current practice. The marginal party in this case would have to decide whether it prefers to retain some political power by not voting for its own alternative – thereby in practice reducing its own significance – or voting for its own alternative mainly as a symbolic act. The first alternative is more efficient at reducing uncertainty, and this would therefore strengthen the incumbent coalition. Hence, it is highly desirable that parliament codifies its voting rules.

5.5 Strengthening the budget cycle

As stated previously, a conscious design principle underlying the reform was to move the centre of gravity of the process towards spring in order to stabilise the basic parameters of fiscal policy. This was expressed via the cabinet meeting in March/April, where consensus was established among cabinet members on the important parameters of the budget, while expenditure ceilings (global- and expenditure area-related) for the next period were fixed. The result was presented in the Spring Fiscal Policy Bill and confirmed by parliament. Over time, the centre of gravity has drifted back towards autumn, and the cabinet meeting in spring has lost importance. The main argument in favour of these changes seems to be the problem of forecasting. In a rapidly changing economic environment, a decision in spring is six months further away from the budget period. By contrast, the normal course of action is to add only the expenditure ceiling pertaining to the third year, while keeping the previously decided ceilings, and six months does not seem to be a significant difference from that perspective. It makes a difference for the upcoming budget year, but the ceiling for this year has already been fixed, and uncertainty

with respect to macroeconomic changes should in any case be managed via the budget margin.

As for the cabinet meeting, a session in early spring helps stabilise the budget process both internally in government offices and with society outside. The cabinet as such is an important confirmation of the top-down approach. In summary, there are strong reasons for reverting to the original budget cycle following the reform, where basic parameters were fixed at an earlier stage.

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